BUILDING BACK STRONGER – PART 1

Zombie companies: Latent or irrecoverable?

This two-part series examines zombie companies, their impact on stakeholders and the overall economy, as well as suggestions on what actions stakeholders should take to achieve a sustainable turnaround for a latent zombie and a path to future growth.

Current state

Prior to the financial crisis of 2007-2008, almost 50 percent of US companies showed a high probability of distress and insolvency as measured by the Altman Z-score. Recently, the pandemic precipitated a period of low oil prices and budget tightening across Gulf Cooperation Council (GCC) countries. In order to understand the impact of this changing economic environment across the region, we computed the Z-score for 401 listed companies across the GCC and the results demonstrate a parallel to the pre-crisis situation in the US: c.47 percent of those companies fell in the category of perceived high probability of distress leading to insolvency.

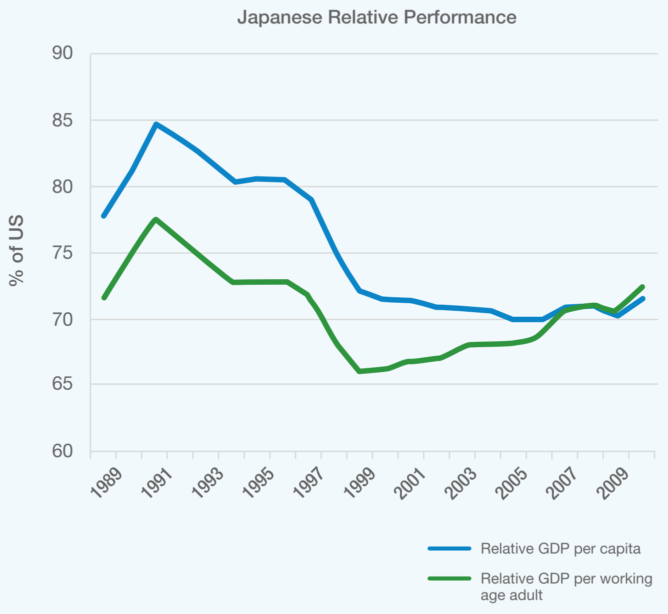
This does not mean that these companies are headed for imminent failure, since countries like the UAE have taken positive measures to strengthen and improve their business environment (for instance through the Targeted Economic Support Scheme post Covid); however it does indicate a presence of some companies that may be operating as “zombies” across the region.

What are zombie companies?

Originating in Japan, the term “zombie company” refers to companies that generate only enough cash to pay interest on their debts. In 1991, as the asset price bubble collapsed, banks continued supporting distressed firms heading towards failure instead of letting them go bankrupt. This ultimately led to a long period of economic stagnation known as the “lost decade” (Figure 1). The term regained its popularity in 2008 when many US companies were being bailed out by the US Troubled Asset Relief Program (TARP).

The Altman Z-score (a variation of the traditional z-score in statistics) is based on five financial ratios that can be calculated from data found on a company’s financial statements. It uses profitability, leverage, liquidity, solvency, and activity to predict whether a company has a high probability of becoming insolvent.

Japan GDP performance relative to US [Figure 1]



Source: Paul Krugman 2013 (NY Times)

Today, there is an increase in GCC-based companies unable to make their loan repayments and therefore could be considered zombie companies. This is evidenced by the increasing rate of total non-performing loans (NPL) and provisions across the region.

What is the impact of zombie companies?

Zombie companies have various impacts across stakeholders, even prior to any significant insolvency event. Their impact across the wider economy is also felt through lower productivity, lack of investment and diversion of scarce resources away from better uses. Research by the Organisation for Economic Cooperation and Development (OECD) states that:

> Zombies hamper productivity growth, diverting credit, investment and skills from flowing to more productive and successful firms. They also decelerate the diffusion of best practices and new technologies across an economy. At the company level, uncompetitive zombie companies can negatively impact pricing power, reduce return on equity, and lower market valuations of otherwise healthy companies.
>
> **"The economic impact of keeping zombie companies afloat"**
> **– Mark Story August 2020**

In addition, if a zombie company is not turned around, and collapses in a disorderly manner, it can be an even greater threat to immediate stakeholders, the wider economy and government development strategy. Zombie companies often only become visible when liquidity runs out and there is a cash crisis triggering a default on loans. However, a lack of liquidity is largely a symptom of distress, not the cause.

Alvarez & Marsal's (A&M) Q2 2021 UAE Banking Pulse showed the banking sector in the UAE remains stable on the back of the Targeted Economic Support Scheme (TESS) and the UAE's strong fiscal and external positions supporting the fundamentals of the banking sector.

How do companies become zombies?

A downturn in the global economy, such as the one caused by the pandemic, pushes many businesses to failure. However, many of these businesses were already on their way to becoming zombies, with fundamental issues in their business models making them vulnerable to existential shock. The reality is that the pandemic simply exposed their weaknesses.

In fact, many high-profile failures and restructurings of zombie companies over the past 20 years have been driven by an inability to keep up with rapid developments in technology (e.g., Blockbuster vs. Netflix, Nokia vs. Apple, Polaroid vs. Kodak). Fundamentally, these businesses became less relevant to their customers and entered severe decline, which was irreversible for core parts of their business. The root causes of the downfall of these prominent business failures were fairly obvious. Simply extending additional funding to these types of failing businesses (without a fundamental shift in their operating model) would not have been the correct approach.

Unfortunately, the more subtle symptoms of a company in decline often go undetected for months or even years until a liquidity crunch occurs, especially when the triggers of decline are internal.

Root causes

Root causes of zombie companies are often subtle. Businesses can appear healthy and even profitable, right up until they run out of cash. Common causes in the GCC include:

- Incoherent strategy and operating models: For example, some groups expand over decades to cover disparate, non-complimentary sectors or fail to adjust their business model to changing market dynamics. Often, one core area of the business generates cash drained by other failing group companies.
- Centralisation of power and deference to seniority: Whilst a corporate hierarchy must be respected, the level of test and challenge required by a young workforce with diverse working cultures is often not encouraged, leading to slow decision making and inefficient processes that fail to react quickly to business needs.
- Weak corporate governance: Duality, succession and lack of internal controls can cause issues that can then lead to a conflict of interest or lack of proper scrutiny of managements decisions.
- Low labour costs: Inefficient processes and a lack of investment in digitization and IT are often masked by low labour costs. This can also impact reporting, in which case management may not have the level of information required in a timely manner to steer the business effectively.

Is this a latent zombie or irrecoverable?

Many root causes can be identified only by gaining access into the inner workings of an organisation. However, there are questions that business owners, lenders and other stakeholder can ask to identify whether this is a latent zombie in need of a turnaround, or one whose market has died and is now irrecoverable.

Some of those questions are:

- What does the sales pipeline look like? How has the win/loss ratio evolved?
- What are customers saying?
- What are competitors doing?
- What do key operational KPIs look like compared to best practice?
- What is the business landscape expected to be in core markets in the long term and how should the business anticipate these changes?

In 2018, two years before the world started wearing face masks and lockdowns became common place, retail chains **Topshop and Topman** booked a huge £505 million loss and sales fell by almost 10% as they struggled to compete with rival online retailers. By failing to invest sufficiently in building an online presence, their underlying business was weakened, as online percentage of total retail sales tripled in their core markets over the course of a decade with the business not responding sufficiently.

In 2020, and for the first time in history, more than half of the spend of customers moved online. Fashion retailers that didn't adapt their business models in time failed. The Arcadia group, which housed Topshop & Topman was bought by ASOS, leaving behind a retail portfolio of approximately 500 shops. Similarly, Debenhams, which failed to adapt sufficiently to a online model, was acquired by Boohoo, leaving behind 118 stores.

- Are skilled management members leaving/are there gaps?
- Are there non-core parts of the business diverting attention?

The answers to these questions can help assess whether the zombie is latent or irrecoverable and anticipate what will be seen in the financials: lower revenues, reduced margins, and reduced cash flows. A latent zombie has potential for turnaround even when existing conditions may appear to indicate no future for the business. By formulating a set of questions relevant to the type of business and asking them regularly, management can begin to shift from fire fighting on an ongoing basis to developing a plan to turnaround a latent zombie. Zombies that don't adopt this approach, in a formalized and recurring manner, have a heightened risk of becoming irrecoverable. Ultimately, similar to a doctor prescribing a pain killer for a severe injury, unless the root cause is addressed, it will only get worse.

In the next article in this two-part series, we will examine key activities that a sustainable turnaround should include to successfully revive a latent zombie.

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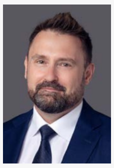

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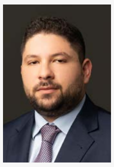

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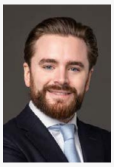

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